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Management Reports

Only a Few Are Appearing in Annual Reports

Frank A. Brown, MBA, CPA
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The inclusion of a Management Report in the annual report to shareholders is a fairly recent development in financial reporting. A Management Report usually includes an affirmation of the company of its responsibility for the financial statements and frequently comments on such related matters as the adequacy of internal controls, the role of its audit committee and the role of the independent and internal auditors. This article discusses the developments which gave impetus to management reporting and to evaluate management reports which are included in the annual report to shareholders for a broad range of publicly held companies.

BACKGROUND

The issuance of management reports which cover internal accounting controls is a product of the growing interest in internal control which began in response to disclosures by many companies of questionable or illegal foreign payments. Congress passed the Foreign Corrupt Practices Act of 1977 as a means of attempting to deter such payments by U.S. companies. The passage of the Act requires publicly held companies to maintain an internal control system sufficient to provide reasonable assurance of meeting the various objectives specified in current accounting literature and to maintain accurate records. The accounting provisions of the Act are incorporated into Section 13(b)(2) of the Securities Exchange Act.

COHEN COMMISSION

Management reporting on internal control was given additional impetus in 1978 when the "Report, Conclusions, and Recommendations" (Cohen Commission) was issued. The Cohen Commission recommended that a report by management should be included in the financial statements, and that the auditor's traditional role be expanded to include a study and evaluation upon which to form a conclusion whether the controls over the major parts of the accounting system provided reasonable assurance that there were no material weaknesses. The independent auditor's report would state whether the auditor concurred with management's description of the system and controls. It further states that "The report by management should separate clearly those items for which the auditor is accepting some responsibility from those for which he is not and avoid purely subjective judgements designed to impress users with the quality of management." [p. 77] The following is a summary of the suggestions for the content of the Management Report based upon the recommendations of the Cohen Commission:

1. A statement by management of responsibility for the financial statements.
2. Assurances that the information is presented in conformity with GAAP appropriate in the circumstances and that all material uncertainties have been appropriately accounted

for or disclosed.

3. An indication that legal counsel has been consulted regarding the accounting for or disclosure of legal matters and that those matters have been appropriately disclosed.
4. An assessment by management of the accounting system and controls over it, including a description of the inherent limitations of control systems, and a description of the company's response to weaknesses identified by the independent auditor.
5. A description of the work of the company's audit committee and its internal auditors.

FINANCIAL EXECUTIVES INSTITUTE

The Financial Executive Institute (FEI) Committee on Corporate Reporting endorsed the Cohen Commission's recommendation that financial statements should include a Management Report. The FEI believed that the report would further public understanding of the roles of management and the outside auditor. The FEI concluded that the management report should emphasize that the primary responsibility for financial statements and representations related thereto rests with management and not the public accountant.

In 1978 the FEI issued a letter to its members that stated its committee's conclusions as to the usefulness of the Management Report and included possible suggestions as to the various subjects which should be considered for inclusion in the report. One suggestion was that management make a statement that it is responsible for the preparation and presentation of financial statements in conformity with GAAP and that other financial information included in the annual report is consistent with that in the financial statements.

The letter also suggested that management recognize its responsibility for maintaining a system of internal accounting control designed to provide reasonable assurance as to the integrity of the financial records and the protection of assets. A summary statement was also suggested in which management would state its overall assessment of the effectiveness of the internal accounting control system.

The FEI also suggested that a statement be included as to the responsibilities of the company's board of directors and its independent audit committee. A statement as to the responsibility of these two respective bodies could include such matters as determining that management fulfills its responsibility in the preparation of financial statements and the engagement of an independent public accountant. Management was also encouraged to consider including a statement to give assurance that the independent auditors had full and free access to meet with the audit committee, without management present, to discuss the results of their examination, their opinions on the internal accounting controls, and the quality of financial reporting.

Other matters which might be discussed would include change in independent auditors, references to ethical and legal policies for domestic and international business activities, reference to the company's social responsibilities, and a discussion of any significant uncertainties included in the statements. The FEI's letter also stated that the signature of the chief financial and/or the chief executive officers of the company might add stature to the Management Report.

AICPA'S REPORT BY MANAGEMENT — SPECIAL ADVISORY COMMITTEE

This Committee of the AICPA consisted of financial executives, attorneys and other users of financial information. Its report, issued in 1978, discussed the form and content of a report by management and recommended that such a report include an assessment of the company's system of internal accounting control and that the report on internal accounting controls should be limited to errors or irregularities that could be material to the financial statements.

SECURITIES AND EXCHANGE COMMISSION (SEC)

In 1979 the SEC issued proposed release No. 34-15772 in response to the internal control objectives specified in the Foreign Corrupt Practices Act. The Act provided that

Exhibit I Dimensions of The Management Responsibility Statement That Were Examined

- I. Does management claim responsibility for the financial statements?
- II. Does the statement mention the firm's internal control and accounting system?
- III. Are the firm's policies and procedures conducive to good internal control and/or ethical business practices?
- IV. Does the statement mention that the internal control system is monitored by the firm's independent auditors?
- V. Does that statement state that other information contained in the report is consistent with the financial statements?
- VI. Are the financial statements prepared in conformity with generally accepted accounting principles?
- VII. Does the firm have an audit committee comprised of non-management members?
- VIII. Does the auditors (internal and independent) have free access to the audit committee?
- IX. Is the statement signed?

companies would publicly report on whether their system of internal control met the specified objectives of the Act. The public reporting by management would begin with annual reports to shareholders and Form 10-K's for fiscal years ending after December 15, 1979. The proposed rule would be implemented in two steps as follows:

Proposed Requirement for 1979
(applicable to fiscal years ending after December 15, 1979 and before December 16, 1980)

A report by management stating:

- (1) Management's opinion on whether the system of internal accounting control of the company and its subsidiaries provided reasonable assurance that the objectives described in the Foreign Corrupt Practices Act have been achieved *as of the latest year end*, and
- (2) A description of any material weaknesses in internal accounting control which have been communicated by the independent auditors of the company or its subsidiaries which were not corrected and the reasons why they have not been corrected.

In the first year, there would be no additional procedures and no report by the independent auditors.

Proposed Requirement for 1980 and Thereafter (applicable to fiscal years ending after December 15, 1980)

1. A report by management which includes the same information as the 1979 report; however, *it must cover the full periods* ending after December 15, 1980 for which audited statements of income are presented.
2. An examination of the Management Report by independent auditors and a report by the auditors giving their opinion as to (a) whether management's representations regarding internal accounting control are consistent with the results of management's evaluation of its system and (b) whether such representations are reasonable with respect to transactions and assets in amounts which would be material when measured in relation to the company's financial statements.

The SEC has announced that the proposed requirements would not be acted upon until early 1980 and the effective date would probably be mid-1980. Therefore, there is no required SEC public reporting on systems of internal control for calendar year 1979.

Examination of 1978 Annual Reports

In order to determine the presence and content of Management Reports appearing in annual reports before such reports were required, 195 annual reports for the 1978 fiscal year of a broad range of publicly held companies were obtained. The 30 annual reports that contained Management Reports were examined regarding the dimensions appearing in Exhibit I.

Table I contains the results of the report examination for the first eight dimensions that appear in Exhibit I. All but one company's management report claimed responsibility for the financial statements. In that case the Management Report was headed "Preparation of Financial Statements," appeared next to the independent auditors' report, was worded similar to the other 29 Management Reports but never claimed responsibility for the financial statements. "Management is responsible for the integrity of the financial data reported by the company" was typical of the wording used.

All but one Management Report briefly mentioned or described the internal control and accounting

systems used by the companies. Twenty-four mentioned that the company had such policies and procedures that fostered good internal control and/or ethical business practices. One stated that the company's policies and procedures are translated into numerous languages and distributed to its employees throughout the world. While it might be assumed that all of the independent auditors of the 30 companies would monitor the internal control systems of the companies, only 20 so stated. Reports of eleven firms explicitly stated that other information contained in the annual report was consistent with the data in the financial statements.

With the exception of two companies, all Management Reports stated that the financial statements were prepared in conformity with GAAP. Nineteen reports stated that the auditors (internal and external) had free access to the audit committee. The seventeen reports bearing signatures had a mixture of officers signing them. Nine independent auditing firms audited the 30 companies having "management reports." No discernable pattern was noted between the dimensions included or excluded in the Management Reports and the auditing firm associated with the company.

The results of our study show that the Management Reports that appeared in the annual reports would not be in compliance with the SEC proposed requirements and none specifically mentioned whether the company's internal control system was adequate to comply with the Foreign Corrupt Practices Act. In no case was there an auditor's report

issued on the company's management report. The proposed SEC requirement for 1980 and thereafter with regard to that issue requires that an opinion be given on (a) whether management's representations regarding internal accounting control are consistent with the results of management's evaluation of its system and (b) whether representations are reasonable with respect to transactions and assets in amounts which would be material when measured in relation to the company's financial statements.

The SEC gives no guidance on the question of what is "material when measured in relation to the company's financial statements." Without such guidance it will be difficult for auditors to conduct comparable audits on such Management Reports.

CONCLUSION

This article has discussed the developments which have given impetus to the current status of management reporting in annual reports and evaluated the Management Reports that appeared in 30 annual reports out of a sample of 195.

Although the Cohen Commission, the FEI and the AICPA have all addressed the management reporting issue, it appears that the SEC will be the entity which will issue the reporting requirements on management reporting. Should the current SEC proposals be implemented the results of our study indicate that future Management Reports would change substantially from those appearing in 1978 annual reports. Ω

Table I

Presence of Dimension Items I thru VIII

Item	Present	Absent
I. Responsibility claimed	29	1
II. Internal control and accounting systems	29	1
III. Policies and procedures	24	6
IV. CPA firm monitors internal control	20	10
V. Other information consistent	11	19
VI. Conformity with GAAP	28	2
VII. Audit Committee	30	0
VIII. Free access for auditors	19	11

References

- Financial Executives Institute, letters to members, June 6, 1978.
 Securities Exchange Act of 1934, 15 U.S.C. 78m(b) (2) (B).
 The Commission on Auditors' Responsibilities: "Report, Conclusions and Recommendations" (1978).

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